Zimbabwe´s Hyperinflation: The House is on Fire – But Does The Government Know it is Dousing the Flames with Petrol?

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At the end of July 2006, a Supplementary Budget statement was made by the Minister of Finance and a bi-annual Monetary Policy Statement (MPS) was presented by the Governor of the Reserve Bank of Zimbabwe (RBZ). These two statements included certain changes in policies, but not the ones needed to address the deep economic crisis into which the country has been thrust. Of particular concern is the pro-inflationary character of both the fiscal and monetary measures which were announced. The reality of the policy positions being adopted stands in marked contradistinction to the concerns articulated by both officials, the most prominent one being that 'inflation is the nation's number one economic enemy'.

Unabated Economic Decline

The economic situation is extremely serious. In the real economy, Zimbabwe is in the eighth consecutive year of GDP decline, the cumulative effect being a loss of national output of more than 30%. Formal employment has probably declined even more sharply, by around 40%. With the crucial role that formal sector employees play in extended families, this fall is one of the many contributing factors to the growing extent and depth of poverty. Foreign currency earnings have collapsed to less than half the 1996 peak level of US$ 3,100 million. The consequent shortages of fuel, electricity, raw materials and spare parts are a major reason for the decline in economic output.

Another important cause is the destruction of productive capacity and loss of skilled workers through emigration. This is most evident in the agricultural sector, where, to take irrigation capacity as an example, about 50,000 hectares of national irrigation land of some 186,590 hectares existing prior to the fast track land reform has been made inoperable due to vandalism, theft and neglect. Levels of agricultural production have

fallen dramatically. Maize production in the last season is not likely to have exceeded 800,000 tonnes, 40% of the 2 million tonnes produced ten years earlier in 1996. Tobacco production has similarly fallen from 179,000 tonnes in 1996 to 50,000 tonnes in 2006. The rate of de-industrialisation has also been dramatic, the volume index of production falling by 42% between 1996 and 2006.

The service sectors have also been extensively damaged, most obviously the tourism industry which has moved from being an important emerging sector for foreign currency and employment generation to being virtually dormant. The banking sector has been subject to enormous stresses, the initial crisis being deliberately precipitated by the RBZ governor when he first came into office at the end of 2003. The banks which were not able to survive an extremely rapid increase in interest rates were offered the poison chalice of a distressed bank facility, and this ultimately led to some unnecessarily painful bank closures. A merger encouraged by RBZ during 2005 failed due to corrupt dealings by staff of some of the participants (undetected by the RBZ regulators), and this led to a further collapse of confidence, particularly in local banks. In 2006, the situation in the banking sector superficially seems to have stabilised, but the reality is that, in the face of continuous changes in monetary policies, the banks are operating in an extremely risky environment. Sudden opportunities to make disproportionately large profits arise, and then things change towards loss-making positions. The legacy of distrust of the banks, coupled with the fact that retailers and others have become increasingly reluctant to accept cheques, have driven the public into increasing use of cash for transactions purposes.

The extent of macro-economic instability is clear from all of the basic monetary indicators:.

- ***Inflation:*** Annual inflation rose above 1000% per annum in April 2006 and was close to 1200% in May and June 2006. This 'headline' inflation figure is calculated on the basis of comparing the consumer price index (CPI) with the corresponding month in the previous year. Because the July 2005 CPI rose exceptionally fast (increasing 47% in one month), in July 2006 the annual rate fell to just below 1000% per annum. Of more concern than the annual rate is the month-to-month rate. In 2006, month-to-month rates have varied between 17% and 28%, the latest rate for July 2006 being 25%.

- ***Interest rates*** are also extremely high. Before the MPS, overnight accommodation rates at the central bank were set at 850%-900% per annum. The 91-day Treasury Bill interest rates have been of the order of 350% in the first half of 2006, but the rates have been changed with unprecedented frequency, the associated uncertainty being one of the many weaknesses of the policy environment.

- ***Devaluation:*** The loss of value of the local currency in domestic markets is mirrored by the extent of depreciation of the Zimbabwe dollar foreign exchange rate. In 1996, a decade ago, the exchange rate was Z$10/US$. Since then, it has been officially depreciated by 99.996% to reach Z$250,000:US$ (old Z$), as announced in the recent MPS statement. It has depreciated even more dramatically on the parallel market (reaching Z$650,000:US$ within days of the MPS).

In the face of very high inflation, declining incomes, increased instability and uncertainty and the abrogation of the rule of law, levels of savings and investment in the economy have declined to tiny proportions of GDP. Investment falls have been evident not only in the private sector, but also among the major parastatals. The need for expansion of capacity in infrastructure is now particularly acute. Lack of expenditure on maintenance poses the threat that even the existing infrastructure will in future be increasingly unreliable. The most striking example is the constant power cuts in large measure due to declining generation capacity of the units at Hwange power station.

Prices of services provided by the parastatals have not been allowed to keep pace with inflation, with the result that these enterprises have had inadequate revenue streams and accumulated enormous debts. The level of implied subsidy has recently been most evident in the case of the Grain Marketing Board, which has been required to purchase maize from farmers at Z$31 million per tonne and sell grain to millers at Z$0.6 million per tonne. The debts of the parastatals and other public entities, such as local authorities, compound the official domestic debt level which stood at Z$50 trillion (or 6% of GDP) in mid July. Foreign debts of US$ 4 billion, together with arrears in foreign payments of US$ 2 billion, are equivalent to 180% of GDP at the official exchange rate and around 430% of GDP at the parallel rate.

Fiscal Policy feeds Hyperinflation: Financing State Expenditure by Printing Money

No explicit macro-economic assumptions were given in the 2006 Budget Statement presented to Parliament in December 2005, but the assumptions which were implicit in that document were startlingly out of line with developments in the economy in the following six months. Thus when the Supplementary Budget was presented in July 2006, the levels of revenue and expenditure were increased by multiples of the original budget estimates. The changes are shown in the following table.

2006 Budget Figures

Z$ trillion (old Z$)	Dec 2005	July 2006
Revenue	110	250
Expenditure	124	451
Deficit	-14	-201
GDP estimate	302	840
%GDP	-4.6%	-23.9%

Note: GDP estimate implict in Dec 2005, announced in July 2006

The revised budget deficit of nearly 24% of GDP is a more credible figure than the original budget deficit. As it cannot be financed from foreign sources or by local savings, it will in effect be financed by printing money. Inflationary finance is a matter of concern when a budget deficit is over 4% of GDP. Financing a 24% budget deficit in this way portends a dramatic increase in inflation.

As if this situation were not bad enough, the issue of so-called “quasi-fiscal” expenditures needs also to be brought into the picture. These are off-budget expenditures which have been made in recent years by the Reserve Bank, supposedly to offset the impact of monetary policies on certain favoured economic actors. Far from being marginal, these quasi-fiscal payments have rivalled the expenditure levels in the official national budget. When combined with the subsidies to the parastatals, Zimbabwe’s total public sector deficit has been estimated

by the IMF to be more like 60% of GDP.

Monetary Policies adding further Momentum to Inflation

Large quasi-fiscal payments originating from the central bank are just one aspect of the flamboyant style of the incumbent RBZ governor. In his first MPS, when he came into office in December 2003, he correctly identified many of the problems, but since that time has taken the economy through a roller-coaster of half-baked policy changes, many of which fall outside of the normal mandate of a central bank governor. At times, there have been some short-term improvements, but as the approach has lacked coherence, the underlying situation has in fact been worsened. In respect of inflation, for example, the level of around 600% in December 2003 was reduced to 124% in March 2005, but has since increased to close to 1200% in recent months.

During the last few months prior to the July 2006 MPS, the banks had been made to operate in a knife-edge situation whereby any liquidity surplus or deficit at the end of each day would incur huge penalties. A surplus was either to be used to purchase two year Treasury Bills at a 200% rate of interest, or else had to be deposited with the Reserve Bank for 30 days at zero interest. Banks having a shortfall, on the other hand, had to borrow from the Reserve Bank at overnight interest rates of 850% (when secured with Treasury Bills) or 900% otherwise. In an environment of inflation of the order of 1200%, both these compulsory mechanisms entailed significant costs. Much of the energy of the banks was therefore directed to liquidity management. The normal role of a bank was also disrupted in another important way in that the risk of default by customers borrowing at the prevailing interest rates (minimum bank lending rates being of the order of 170% per annum) was so high that banks tried to avoid engaging in lending. As lending is the fundamental economic role of the banks, this distortion is one of the many factors that has been suppressing the level of economic activity in the economy.

As long as interest rates (compounded according to the tenor of the instrument concerned) are less than the rate of inflation, there is no incentive to save and every incentive to spend money on goods, or to purchase other types of assets whose value may keep up with inflation. Thus when interest rates are suppressed, inflationary pressures grow in domestic markets, the stock market and property markets boom irrespective of fundamentals and there is enormous pressure on the parallel foreign currency market as people seek to hold foreign currency rather than local money. The result of the latter factor is a sharp depreciation of the exchange rate, which raises the local currency cost of all imports and thereby adds an important cost-push element to the inflationary spiral.

At the beginning of 2006, interest rates were well below the level of inflation, the above mechanisms were at play, and inflation was rising. In February, the Reserve Bank increased money market interest rates significantly, raising returns on three month Treasury Bills to positive levels in relation to inflation and introducing a one year index-linked Treasury Bill. This turned the money market into an attractive avenue for savings, and resources flowed out of the stock exchange and other forms of investment into the money market. This approach was not sustained, however, the reason being that the authorities are between a rock and hard place when it comes to interest policy.

Increasing interest rates is the right thing to do to curb inflation, but requires provision to be made in the budget for the resulting interest payments. Whereas in the original budget for 2006, interest payments were set at Z$17.5 trillion (old Z$), in the revised budget interest payments of Z$119.5 trillion are envisaged (14% of GDP), with independent economists predicting that they will be even higher.

Against this background, the monetary policy announcements in the July MPS in effect threw in the towel on trying to curb inflation. The instruments which could have been used to tighten monetary conditions were in fact used to loosen them. Banks were called upon to reduce their lending rates and statutory reserve requirements were eased. A new facility was introduced for small-scale enterprises and banks were exhorted to match the Z$16 trillion (old Z$) which RBZ said it would be providing for this purpose. There is already a concessionary facility in place for the agricultural sector, which is supposed to provide cheap credit to the new farmers. The problem with such facilities in an environment where money market interest rates are multiples of the interest rates available to participants is that it will always be more lucrative to re-deploy the funds so as to obtain the certain returns from money market investments, rather than using them for the uncertain and more demanding purposes for which they were intended.

The RBZ overnight accommodation rates were reduced from 850% to 300% for secured and 900% to 350% for unsecured lending, which is equivalent to 1884%-3157% per annum when compounded. This implies that interest on overnight loans is still ahead of inflation, so this particular change is not in itself pro-inflationary, but the symbolism of such a sharp drop in interest rates is being taken as a signal by the markets that inflation is now going to increase without restraint. Another factor adding weight to this view is the inadequate devaluation of the currency announced in the MPS (from Z$101,000:US$ to Z$250,000: US$, old Z$). The parallel market exchange rate had already fallen from around Z$135,000 at the start of the year to Z$500,000:US$ prior to the MPS and dropped further to Z$650,000:US$ immediately afterwards. There were some positive changes in the MPS (allowing indefinite retention of 75% of export proceeds), but without the exchange rate adequately rewarding exporters, the shortages of foreign currency will persist and will continue to inject large doses of imported inflation into the economy.

Replacing the Old Notes – Off go 3 Zeroes but for how long ?

Any debate that might have taken place over the weaknesses of the MPS in respect of its policy content have been sidelined and overshadowed by the removal of the notes in circulation and their replacement with a new denomination having a thousand times the value of the old currency. This 'knocking off of three zeroes' was necessitated first and foremost by the inability of computer systems to handle the number of digits required for accounting purposes. Amounts that were in millions one or two years ago had risen to billions and trillions. Reprogramming computer systems to expand the size of fields required for the swollen numbers would have required significant expenditure of foreign currency and was simply not feasible. Changing the 'bearer cheques' (temporary bank notes - Zimbabwe has not had proper currency for some years) was regarded as a more expedient solution.

Two other motivations were put forward by the RBZ Governor in his speech. The first was to reduce the burden on ordinary Zimbabweans of having to carry large volumes of cash to make payments for basic goods and services. The time taken to count the notes in shops and to handle and bank the cash had become a nightmare for people running businesses that deal in cash. However, in view of the level of inflation and the inevitability that it will rise further, the convenience of shoppers and operations of commercial establishments and banks would have been better served by removing 6 zeroes.

Limiting Money Conversion: Crack Down on Parallel Markets, or State Theft?

The second motivation that emerged in the MPS was to use the opportunity to crack down on those engaged in parallel market activity. To achieve this, very low ceilings were specified on the amount of old currency that could be deposited at banks by individuals and corporates before the deadline for the old notes expires (21st August). The Governor alleges that the bulk of currency in issue was outside of the banking system, with much of it being stashed outside the country. Initially it was said that Z$35 trillion out of a total of Z$40 trillion was outside the banking system, though subsequently very different figures were given, suggesting that the authorities do not even know how much of the old currency had been issued, let alone where it was to be located. Whatever the exact numbers, the idea that there was huge hoarding of a currency which was losing value on a daily basis seems highly unlikely to be true.

However, the claims about hoarding and parallel market activities have been used as a pretext to expropriate money from individuals and businesses. Road blocks have been set up throughout the country to stop and search vehicles for currency and raids have been made on houses and businesses. The amounts that people are allowed to have in their possession are inconsequential in a highly inflationary, increasingly cash-based economy (the equivalent for individuals of about US$200 and for businesses US$10,000, using the parallel rate at the time of the MPS statement). The enforcement has been carried out in military fashion, with army personnel and youth militia as well as the police being involved in the operations. In a country increasingly subject to abrogation of the rule of law, the operation has involved breaching norms of separation of powers and protection of property. Instead, those carrying out searches have been given discretionary power to decide on what money can be held, with incidents being reported of money being confiscated in total without the issuance of any receipt. This bears the hallmarks of organised looting or state theft.

Critics of the present government have often claimed that the largest players in parallel markets are senior officials and persons closely linked to the ruling elite. The adverse reactions from some quarters within the ruling party to the requirements imposed on the surrender of old currency seems to support this view. An even more Machiavellian speculation that has been voiced in some quarters is that the measures were imposed by the RBZ Governor specifically to target certain groups in the context of the competition for succession which is on-going within the ruling party. Whether or not this is true, the dissatisfaction with the measures imposed by the Governor was expressed not just verbally, but through a gang being hired to inflict damage on his property. He now has additional bodyguards in attendance.

Conclusion

Speculation, hoarding and parallel market activity are inevitable responses to distorted economic incentives. No amount of policing will eliminate such activities as long as the underlying policy framework is inadequate. Unfortunately, the cumulative result of ill-conceived, half-hearted stabilisation measures has resulted in an economic situation which is much more difficult to address than it was even a few years ago, when the crisis was already deemed to be all but intractable. The government blames 'international sanctions' for the state of the economy, but this allegation does not stand up to any scrutiny. There are personal sanctions against members of a government that has practiced systematic human rights abuses against its people, but the lack of international economic support for the government's programmes is not a question of 'sanctions'. It stems from a rational appraisal of the lack of coherence of the economic policies and of the systemic corruption that has become an entrenched aspect of the way the country is being mis-governed.

To stabilise the macro-economy and set the country onto a path of positive growth would firstly require restoration of the fundamental requirements of a modern economy. This particularly implies adherence to the rule of law, and secondly the formulation and implementation of a comprehensive package of fiscal, monetary, sectoral and social policies, designed to complement and reinforce one another. To make this work would require that domestic economic actors and external agencies believe that the programme has a good chance of succeeding and will be consistently implemented over the many years of effort that will be required. They will then be prepared to provide the support that will ensure that this does in fact happen. Confidence and credibility are therefore fundamental, and it is these elements which have been entirely squandered by the incumbent government. In such circumstances, it is clear that in the absence of meaningful political change no sustainable improvement in Zimbabwe's economic prospects is possible.

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